

The University of Tennessee

**For the Year Ended
June 30, 2002**

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**STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY**

State Capitol
Nashville, Tennessee 37243-0260
(615) 741-2501

John G. Morgan
Comptroller

March 11, 2003

The Honorable Phil Bredesen, Governor
and

Members of the General Assembly
State Capitol
Nashville, Tennessee 37243

and
The Honorable J. Steven Ennis, Chairman
Finance and Administration Committee
Board of Trustees
The University of Tennessee
Knoxville, Tennessee 37996-0180

and
Dr. John W. Shumaker, President
The University of Tennessee
831 Andy Holt Tower
Knoxville, Tennessee 37996-0180

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the University of Tennessee for the year ended June 30, 2002. You will note from the independent auditor's report that an unqualified opinion was given on the fairness of the presentation of the financial statements.

Consideration of internal control over financial reporting and tests of compliance disclosed certain deficiencies, which are detailed in the Results of the Audit section of this report. The university's administration has responded to the audit findings; the responses are included following each finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit findings.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/sds
02/087

State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
The University of Tennessee
For the Year Ended June 30, 2002

AUDIT OBJECTIVES

The objectives of the audit were to consider the university's internal control over financial reporting; to determine compliance with certain provisions of laws, regulations, contracts, and grants; to determine the fairness of the presentation of the financial statements; and to recommend appropriate actions to correct any deficiencies.

INTERNAL CONTROL FINDING

Need to Better Document Programming Changes for the Central Services Accounting System

At the Knoxville campus, the university should develop policies and procedures to better document programming changes for its

Central Services Accounting (CSA) system. Without the effective documentation of programming changes, programmers could potentially perform unauthorized changes to accounting data and student information within the CSA system (page 8).

COMPLIANCE FINDINGS

Failure to Properly Record Serial and Tag Numbers for Federal Equipment

Departmental personnel are failing to enter the serial numbers and tag numbers of equipment purchased with federal funds on the university accounting system. Without the prompt recording of this information on the university's accounting system, the university will lack the

ability to properly safeguard and control these equipment assets (page 8).

Effort Certification Reports Were Not Completed on a Timely Basis*

For the six-month period ended December 31, 2001, effort certification reports were not completed on a timely basis. These reports

document payroll costs charged to federally sponsored grants and contracts (page 9).

Due Diligence Procedures for Perkins Loans Need Improvement

At the University of Tennessee at Chattanooga, federal due diligence procedures for Perkins loans were not followed. Management should ensure that students entering a repayment or default status are contacted at the required intervals stipulated in the *Code of Federal Regulations* (page 11).

Financial Aid Verifications Were Not Properly Conducted

At the University of Tennessee at Chattanooga, for the year ended June 30, 2001, 2 of 21 federal financial aid verifications tested were not properly conducted. Necessary corrections were not submitted (page 14).

Student Status Changes Not Properly Reported

At the University of Tennessee at Knoxville, the university did not always report enrollment changes for Federal Family Education Loan borrowers who dropped classes, withdrew, or graduated (page 15).

Failure to Properly Justify a Sole-Source Contract

The university entered into a noncompetitive (sole-source negotiation) contract with a marketing firm without adequate justification. The university's *Fiscal Policy* allows for a noncompetitive contract when "only one product or service can meet a specific need and the product or service is available from only one source" (page 16).

*This finding is repeated from the prior audit.

OPINION ON THE FINANCIAL STATEMENTS

The opinion on the financial statements is unqualified.

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report, which contains all findings, recommendations, and management comments, please contact

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Audit Report
The University of Tennessee
For the Year Ended June 30, 2002

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The University of Tennessee For the Year Ended June 30, 2002

INTRODUCTION

POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the University of Tennessee. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

BACKGROUND

The University of Tennessee was first established as Blount College in 1794 by the legislature of the Federal Territory. In 1807, the General Assembly renamed the institution East Tennessee College, and in 1840, designated it a university. East Tennessee University was selected by the General Assembly to be Tennessee’s land-grant institution under the terms of the Morrill Act of 1862. In 1879, the General Assembly chose the school to be Tennessee’s state university and changed the name to the University of Tennessee.

Since its establishment, the university has grown into an institution with 20 different colleges and schools. With its campuses, various experiment stations, and extension services, the university provides services throughout the state. The university has three accredited units: The University of Tennessee (Knoxville campus, Health Sciences Center, Space Institute, Institute of Agriculture, and Institute for Public Service), the University of Tennessee at Chattanooga, and the University of Tennessee at Martin.

ORGANIZATION

The University of Tennessee is governed by the University of Tennessee Board of Trustees. In 1968, the board reorganized the institution into a university system, giving a central administrative staff the responsibility for the entire operation of the university. In 2000, the university was reorganized from a four-campus system into three accredited units: the University of Tennessee, the University of Tennessee at Chattanooga, and the University of Tennessee at Martin.

AUDIT SCOPE

The audit was limited to the period July 1, 2001, through June 30, 2002, and was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Financial statements are presented for the year ended June 30, 2002. The University of Tennessee is an integral part of state government. As such, it has been included as a component unit in the *Tennessee Comprehensive Annual Financial Report*.

OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the university's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements;
2. to determine compliance with certain provisions of laws, regulations, contracts, and grants;
3. to determine the fairness of the presentation of the financial statements; and
4. to recommend appropriate actions to correct any deficiencies.

Although this audit was not intended to serve as an organization-wide audit as described in the Single Audit Act, as amended by the Single Audit Act Amendments of 1996, and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, it included tests of compliance with applicable federal laws and regulations and consideration of internal control used in administering federal financial assistance programs. This audit is a segment of the organization-wide audit of the State of Tennessee, which is conducted in accordance with the Single Audit Act.

PRIOR AUDIT FINDINGS

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The university filed its report with the Department of Audit on June 11, 2002. A follow-up of all prior audit findings was conducted as part of the current audit.

RESOLVED AUDIT FINDINGS

The current audit disclosed that the university has corrected previous audit findings concerning the need to properly perform bank reconciliations and the need to adequately collateralize bank deposits.

REPEATED AUDIT FINDING

The prior audit report also contained a finding concerning the fact that effort certification reports were not completed on a timely basis. Reports for the six-month period ended December 31, 2001, were not completed on a timely basis, and the finding is therefore repeated.

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the university's financial statements for the year ended June 30, 2002, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements, as required by auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Reportable conditions, along with recommendations and management's responses, are detailed in the findings and recommendations. Consideration of internal control over financial reporting disclosed no material weaknesses.

Compliance

The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*. Immaterial instances of noncompliance, along with recommendations and management's responses, are included in the findings and recommendations.

Fairness of Financial Statement Presentation

The Division of State Audit has rendered an unqualified opinion on the university's financial statements.



**STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT**

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**Report on Compliance and on Internal Control
Over Financial Reporting Based on an Audit of
Financial Statements Performed in Accordance With
*Government Auditing Standards***

November 22, 2002

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the financial statements of the University of Tennessee, which is a component unit of the State of Tennessee, as of and for the year ended June 30, 2002, and have issued our report thereon dated November 22, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. As discussed in Note 18, the university implemented GASB Statement 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and GASB Statement 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*. The university also implemented GASB Statement 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*, and GASB Statement 38, *Certain Financial Statement Note Disclosures*. The university also changed its capitalization threshold for buildings, land improvements, and infrastructure; discontinued the capitalization of its livestock; and changed its method of capitalizing library holdings. The university also changed its method of accounting for accumulated federal capital contributions under its federal loan programs.

Compliance

As part of obtaining reasonable assurance about whether the university's financial statements are free of material misstatement, we performed tests of the university's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

We did, however, note certain immaterial instances of noncompliance that we have included in the Findings and Recommendations section of this report. We also noted certain other less significant instances of noncompliance, which we have reported to the university's management in a separate letter.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the university's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted one matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the university's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements.

The following reportable condition was noted:

- The university should develop policies and procedures to better document programming changes for its Central Services Accounting system.

This condition is described in the Findings and Recommendations section of this report.

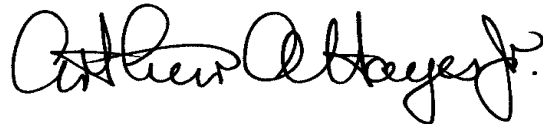
A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe the reportable condition described above is not a material weakness.

The Honorable John G. Morgan
November 22, 2002
Page Three

We also noted other matters involving the internal control over financial reporting, which we have reported to the university's management in a separate letter.

This report is intended solely for the information and use of the General Assembly of the State of Tennessee and management and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record.

Sincerely,

A handwritten signature in black ink, reading "Arthur A. Hayes, Jr." in a cursive style.

Arthur A. Hayes, Jr., CPA,
Director

AAH/sds

FINDINGS AND RECOMMENDATIONS

1. Program change policies and procedures for the Central Services Accounting system need improvement

Finding

At the University of Tennessee at Knoxville, management of the university's Office for Research and Information Technology (ORIT) has not established effective policies and procedures relating to the Central Services Accounting system (CSA). The university uses CSA to maintain student accounts receivable at the Knoxville campus. Because there are only limited policies relating to program changes, university officials were unable to provide documentation of management's authorization and approval of program changes to the CSA system. For example, program change policies did not require the requesting user's identification, the date the change was requested, management's approval, the programmer's identification, descriptions of the change to be made, date completed, and the user's acceptance of the completed change. Without effective program change policies and procedures, programmers could potentially perform unauthorized changes to accounting data and student information within the CSA system.

Recommendation

Management of the university's ORIT should implement effective program change policies and procedures for the CSA system. These policies should require documentation of the requesting user's identification, the date the change was requested, management's approval, the programmer's identification, descriptions of the change to be made, date completed, and the user's acceptance of the completed change.

Management's Comment

We concur. The university's ORIT office will implement program change policies and procedures for the CSA system.

2. Failure to properly record serial numbers and tag numbers for federal equipment

Finding

The university's equipment records are maintained on its accounting system, the Integrated R/3 Information System (IRIS). For 21 of 40 equipment items tested which were purchased with federal research and development funds during the year ended June 30, 2002

(53%), the serial number of the item was not entered in the system. For 15 of the 40 items tested (38%), the tag number was not entered in the system.

The university's *Fiscal Policy* requires that departments "promptly tag equipment and record the tag (inventory) numbers into the accounting system."

Office of Management and Budget Circular A-110, .34f, requires that "equipment records shall be maintained accurately and shall include . . . [the] manufacturer's serial number, model number, federal stock number, national stock number, or other identification number."

Under the university's new IRIS accounting system, equipment items are initially entered in the system during the requisition process. Later, when assets are received, departmental personnel enter the serial number and the tag number for each asset. According to university personnel, departmental staff members are failing to enter this information.

Without the prompt recording of serial numbers and tag numbers on the university's equipment system, the university will lack adequate information to properly safeguard and control its equipment assets.

Recommendation

The university should make revisions to its IRIS accounting system or take other steps to ensure that departmental personnel are consistently entering serial numbers and tag numbers on the university's equipment system.

Management's Comment

We concur. The controller's office will institute a procedure to identify equipment items without serial numbers and tag numbers, and will send a letter to each department asking that the serial number and/or tag number be added to the asset record.

3. Effort certification reports were not completed on a timely basis

Finding

As reported in the previous two audits, effort certification reports were not always completed on a timely basis. The university uses after-the-fact effort certification forms to document the distribution of payroll costs to sponsored agreements. This type of certification is required of all salaried personnel whenever a portion of their salary is charged to a grant or contract account through the university's payroll system. Until December 31, 2001, the university distributed forms either for each academic term or on a monthly basis to applicable staff. The forms were submitted by departmental personnel to a campus business office for

review and then forwarded to the university-wide controller's office. Campus business office personnel made any necessary adjustments to the distribution of payroll cost. From the university-wide controller's office, the forms were forwarded to data entry, where the information from the forms was entered into the university's effort certification audit system. In this system, a record was kept of the forms received and those not received, and a record was kept of significant unresolved payroll distribution variances (greater than 5%). As information was entered, the system automatically checked to make sure that any necessary payroll adjustments had been made. The forms were then filed in the controller's office.

As of December 10, 2002, for the six-month period ending December 31, 2001, 538 of the effort certification reports distributed (11%) had not been returned to the controller's office. These reports had not been submitted to the controller's office by departmental or campus business office personnel or had never been completed by departmental personnel. In addition, based on effort reports that were processed, there were 503 significant unresolved payroll distribution variances at December 10, 2002.

Effort certification forms for the fall 2001 semester at the Knoxville, Chattanooga, and Martin campuses were not distributed until April 2002, and effort certification forms for the fall 2001 quarter at the Memphis campus were not distributed until May 2002. However, federal regulations require that effort reports be prepared at least every six months.

Office of Management and Budget (OMB) Circular A-21, Section J.8, states:

Reports will reasonably reflect the activities for which employees are compensated by the institution. To confirm that the distribution of activity represents a reasonable estimate of the work performed by the employee during the period, the reports will be signed by the employee, principal investigator, or responsible official(s) using suitable means of verification that the work was performed. . . . For professorial and professional staff, the reports will be prepared each academic term, but no less frequently than every six months.

Salary transfer vouchers (Form T-17) are prepared by departmental personnel whenever actual certified time or effort on a grant or contract varies by 5% or more from the percentage of estimated salary charged. Therefore, the failure to prepare effort certification forms on a timely basis and to conduct timely reviews could lead to incorrect charges to federal programs. In addition, if supporting effort reports are never submitted, federal payroll costs are not documented as required per OMB A-21.

As of January 1, 2002, the university began to use a different method of effort certification. The university implemented a Web site in connection with its new accounting system, the Integrated R/3 Information System (IRIS). Effort certification is now performed online on a monthly basis, and necessary transfer vouchers are automatically routed to department heads. The addition of the new Web site and information system has greatly improved both the timeliness and the rate of return of effort reports.

Recommendation

The outstanding effort certification forms for the 2002 fiscal year should be submitted, and any necessary transfer vouchers should be prepared. The significant payroll distribution variances should be resolved.

Management's Comment

We concur. The controller's office will work with the campus business offices to get all forms returned and prepare any necessary salary transfer voucher.

4. Due diligence procedures for Perkins loans need improvement

Finding

Due diligence procedures for Perkins loans entering repayment or default status at the University of Tennessee at Chattanooga are not adequate.

The *Code of Federal Regulations*, Section 34, Part 674.42 (c)(1)(i) through (c)(2)(iii), states that institutions must contact borrowers entering repayment three times during the grace period: 90 days, 150 days, and 240 days after the commencement of the grace period. Section 34, Part 674.43 (a)(1) states, "if the institution uses a coupon payment system, it shall send the coupons to the borrower at least 30 days before the first payment is due."

For the year ended June 30, 2002, testwork was performed on the files of 25 students whose loans entered repayment status during the fiscal year. The following discrepancies were noted:

- a. The 90-day contact letter was mailed 12 to 61 days late for all of the loans tested.
- b. Twenty-three of the 150-day contact letters tested (92%) were mailed 9 to 41 days late.
- c. For 12 of 22 loans tested (55%), the 240-day contact letter was mailed 10 to 73 days late.
- d. The coupon book was not mailed at least 30 days prior to the due date of the first payment for 21 of the 22 loans tested (96%). Twenty of the coupon books were mailed only 23 to 27 days prior to the due date; one coupon book was mailed 40 days after the due date of the first payment.

For the year ended June 30, 2001, testwork was performed on the files of 25 students whose loans entered repayment status during the fiscal year. The following discrepancies were noted:

- a. The 90-day contact letter was mailed 8 to 24 days late for 12 of 25 of the loans tested (48%).
- b. The 90-day contact letter could not be located for one of the loans tested (4%).
- c. Fourteen of the 150-day contact letters tested (56%) were mailed 9 to 14 days late.
- d. For nine of 23 loans tested (39%), the 240-day contact letter was mailed 11 to 12 days late.
- e. The coupon book was not mailed at least 30 days prior to the due date of the first payment for 10 of the 23 loans tested (44%). These coupon books were mailed from 22 to 27 days prior to the due date.

In addition, due diligence procedures for Perkins loans entering default status were not in compliance with federal regulations.

The *Code of Federal Regulations*, Section 34, Part 674.43 (b)(1), (c)(1), (c)(2), and (f), states that institutions must contact defaulted borrowers at set intervals until a payment is made. The required contact times are 15 days, 45 days, 60 days, and 90 days after the first missed payment is due. The 15- and 45-day notices are past-due statements mailed to the borrower. The 60-day contact is a final demand letter. The 90-day contact is a telephone attempt to contact the borrower before the loan is sent to collections.

For the year ended June 30, 2002, testwork was performed on the files of 25 students whose loans entered default status during the fiscal year. The following discrepancies were noted:

- a. The 60-day contact letter (final demand letter) could not be located for two of the students entering default status (8%).
- b. For 23 of the loans tested (92%), the 60-day contact letter (final demand letter) was mailed 16 to 19 days late.
- c. The 90-day phone contact was not made for 21 of the students tested (84%).
- d. Two of the phone contacts tested (8%) were made 18 to 42 days late.

For the year ended June 30, 2001, testwork was performed on the files of 25 students whose loans entered default status during the fiscal year. The following discrepancies were noted:

- a. The 60-day contact letter (final demand letter) could not be located for two of the students entering repayment (8%).
- b. For 23 of the loans tested (92%), the 60-day contact letter (final demand letter) was mailed 16 to 79 days late.
- c. The 90-day phone contact was not made for 20 of the students tested (80%).
- d. One of the phone contacts (4%) was made 34 days late.

At the beginning of each month, management runs a report of the contacts to be made during the month. The report is processed, and the letters are printed and mailed. Management stated that this process takes two to three weeks. Since the contacts are due at the first of each month, the delay inherent in the preparation process often results in the letters being two to three weeks late.

As to the 60-day contact letters sent to borrowers in default status, the university actually sent past-due statements at the 60-day point rather than the final demand letters required by federal regulations. The final demand letters were sent at a later date, resulting in the noncompliance described above.

Recommendation

Management should ensure that students entering repayment or default status for Perkins loans are contacted at the required intervals as stipulated in the *Code of Federal Regulations*. Reports should be run in the middle of each month to identify the contacts to be made in the subsequent month. For borrowers in default, a final demand letter should be mailed at 60 days after the payment due date, not just a past-due notice.

Management's Comment

We concur. Regulations state that contact letters for borrowers entering repayment must be sent out at 90-, 150-, and 240-day intervals. Due to misinterpretation of the regulations, our loan department sent out letters in the subsequent time period resulting in our not meeting the contact requirement for Perkins loans.

Regulations state Perkins loan borrowers entering default status must be contacted at 15, 45, 60, and 90 days after the first payment is missed. The 15- and 45-day notices are past-due

statements. The 60-day contact is the final demand letter, and the 90-day contact is a telephone attempt to contact the borrower before the loan is sent to collections. Our loan department was sending 15-, 30-, 45-, and 60-day past-due statements, demand letters at 75 days, and commencing in-house collection at the 90-day period. We have corrected our procedures with the assistance of the Information Technology department and will be running 15- and 45-day statements, and a final demand letter at 60 days. We will initiate telephone contact on the 90th day.

5. Financial aid verifications were not properly conducted

Finding

At the University of Tennessee at Chattanooga, for the year ended June 30, 2001, the university failed to properly conduct the verification process for 2 of 21 Title IV financial aid recipients tested. These recipients had been selected by the federal government to undergo verification of their application for federal financial aid.

In conducting eligibility verifications, using tax returns and other available data, financial aid personnel at the school verify certain data elements as reported on the student's ISIR (Institutional Student Information Report). Depending on the circumstances, the school may or may not reprocess the student's application information. For the two students above, the application information was verified, and certain information was found to be incorrect. Corrections were submitted, and a revised ISIR was received by the university. However, all necessary corrections were not submitted. For one of the students, a parent's untaxed income of \$8,556 was not included on her application. For the other student, an earned income credit of \$1,755 was reported on the student's application when the student had not received an earned income credit.

Apparently, these errors on the students' applications were not discovered by financial aid personnel in conducting their comparison of each student's Institutional Student Information Report (ISIR) to the tax return submitted by each student.

According to the *2000-2001 Student Financial Aid Handbook*, volume 1, page 179, "Because the effectiveness of the federal student financial aid programs depends on the accuracy of the data students report, schools must verify information provided by [the] student. . . ."

The failure to submit all necessary corrections resulting from the verification process could result in the incorrect awarding of Title IV financial aid. For the two students described above, the amounts awarded were correct.

Recommendation

Financial aid personnel at the University of Tennessee at Chattanooga should institute procedures to ensure that verifications are properly conducted and that all necessary corrections are submitted when reprocessing is deemed necessary.

Management's Comment

We concur. Management strives to ensure that procedures are in place and are being followed to ensure verifications are properly conducted and that all necessary corrections are submitted when reprocessing is deemed necessary. The institution believes it has addressed this issue in several ways since these errors were made. The financial aid office has upgraded the job classification for the person who performs verification from Data Integrity Clerk to Financial Aid Counselor. We believe this will help cut down on yearly turnover we were experiencing which contributed to more human error as new employees had to be trained. In addition, the Financial Aid Counselor assigned to verification and the Assistant Director attended the National Association of Student Financial Aid Administrators training session on verification on March 19, 2002.

6. Student status changes were not properly reported

Finding

At the University of Tennessee at Knoxville, the university did not always report student status changes for Federal Family Education Loan (FFEL) borrowers who dropped classes, withdrew, or graduated. According to the *Student Financial Aid Handbook*, volume 8, page 69:

This information [regarding student status changes] is extremely important, because it is used to determine the student's eligibility for in-school deferments, and the date when the grace period begins.

Schools must report to the National Student Loan Data System (NSLDS) if the student:

- has ceased to be enrolled **at least half time**;
- was accepted for enrollment at the school but did not enroll on at least a half-time basis for the period for which the loan was intended; or
- has changed his or her permanent address.

If a school does not expect to submit a Student Status Confirmation Report (SSCR) within 60 days of becoming aware that any of the above information has changed for any student, the school must notify the NSLDS within 30 days of becoming aware of the change.

Testwork at the University of Tennessee at Knoxville revealed that for 2 of 25 FFEL borrowers tested (8%), enrollment status changes were not reported within the required time frame. One of the students graduated in the spring 2002 term (May 11, 2002), and the other student received academic dismissal on May 22, 2002. These status changes were reported on NSLDS on September 5, 2002.

The failure to report student status changes could result in inappropriate deferments or the failure to properly begin a student's grace period.

Recommendation

University personnel should ensure that student status changes for FFEL loan recipients are reported in compliance with federal regulations.

Management's Comment

We concur. Corrective action has been taken to ensure that students who were dismissed or graduated during the spring semester will now be included in the final enrollment submission for the spring semester. Enrollment status will be reported three times during the fall semester, three times during the spring semester, and one time during the summer semester. Additionally, degree status will be reported on a monthly basis throughout the entire year. The above reporting schedule will ensure that status changes will be reported as required.

7. Failure to properly justify a sole-source contract

Finding

The university entered into a noncompetitive (sole-source negotiation) contract with Educational Marketing Group, Inc., without proper justification. The firm, based in Colorado, contracted with the university for the delivery of marketing research, consulting, and related services. The university's *Fiscal Policy* allows for a noncompetitive contract when "only one product or service can meet a specific need and the product or service is available from only one source." Although the sole-source justification on file at the university did document the specialized abilities of the firm ("they have the expertise in this particular area and a proven track record with major universities and major university systems in higher education"), it did not adequately document that this was the only firm that could provide these particular services.

Many other firms, several based locally, appear to be able to provide marketing services to higher education clients.

University *Fiscal Policy* requires that contracts “be made on a competitive basis whenever possible.” The failure to consider additional vendors when awarding contracts could result in the university paying excess amounts for services or not adequately considering relevant alternatives.

Recommendation

The university’s reasons for the sole-source procurement of services should always be clearly identified and well-documented. As stipulated in the university’s *Fiscal Policy*, the university should enter sole-source contracts only when alternative vendors are not available.

Management’s Comment

We do not concur with the audit finding. The university stringently followed its procurement policies in contracting with the Educational Marketing Group; legal and fiscal reviews were conducted, justification for non-competitive bidding was completed and routed through university purchasing, and required approvals obtained.

The university solicited the services of Educational Marketing Group based upon the need for very specialized integrated marketing services that included creating a unique brand identity, rigorous on-campus consultations and interviews, and extensive analysis of existing internal and external data related to organizational structure and marketing opportunities. A critical factor in sole-source contracting with Educational Marketing Group was the exclusive possession of data from multiple previous engagements in higher education. These specialized services and data for higher education institutions are the hallmark of Educational Marketing Group and not readily available from other firms locally or regionally. Accordingly, due to the specialized nature of the services sought and the creative nature of the product, the university contracted with the nationally recognized firm providing the required deliverables. This action is consistent with university *Fiscal Policy* that requires contracts “be made on a competitive basis whenever possible.” However, because the audit finding questioned the adequacy of sole-source documentation, the university will review its fiscal policies and make revisions if necessary.

Auditor’s Rebuttal

Proper stewardship of public funds requires that all potential vendors who may be able to provide a specific product or service be allowed to provide such product or service through a competitive process. This ensures that such services or products are obtained by the university in

the most economical manner possible and allows all vendors an equal opportunity to provide the needed product or service.

Once again, the university's *Fiscal Policy* allows for a noncompetitive contract when "only one product or service can meet a specific need and the product or service is available from only one source." This was the criterion cited on the supporting sole-source justification form. While the university has documented that the vendor has specialized abilities in this area, it has not documented that the vendor is the sole source of these services. The university should have considered the vendor's specialized abilities, while still awarding the contract on a competitive basis.



**STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT**

**SUITE 1500
JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 401-7897
FAX (615) 532-2765**

Independent Auditor's Report

November 22, 2002

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the accompanying statement of net assets of the University of Tennessee, which is a component unit of the State of Tennessee, as of June 30, 2002, and the related statements of revenues, expenses, and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of the university's management. Our responsibility is to express an opinion on these financial statements, based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the University of Tennessee, as of June 30, 2002, and the revenues, expenses, and changes in net assets and the cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

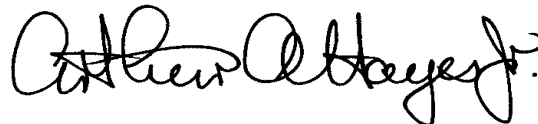
The Honorable John G. Morgan
November 22, 2002
Page Two

As discussed in Note 18, the university implemented GASB Statement 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and GASB Statement 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*. The university also implemented GASB Statement 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*, and GASB Statement 38, *Certain Financial Statement Note Disclosures*. The university also changed its capitalization threshold for buildings, land improvements, and infrastructure; discontinued the capitalization of its livestock; and changed its method of capitalizing library holdings. The university also changed its method of accounting for accumulated federal capital contributions under its federal loan programs.

Management's discussion and analysis on pages 21 through 30 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 22, 2002, on our consideration of the university's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Sincerely,

A handwritten signature in black ink, appearing to read "Arthur A. Hayes Jr.", with a stylized, cursive script.

Arthur A. Hayes, Jr., CPA,
Director

AAH/sds

Management's Discussion and Analysis

This section of the University of Tennessee's annual financial report presents a discussion and analysis of the financial performance of the university during the fiscal year ended June 30, 2002. This discussion has been prepared by management along with the financial statements and related note disclosures and should be read in conjunction with them. The financial statements, notes, and this discussion are the responsibility of management.

Since this is a transition year for the new financial reporting format required by the Governmental Accounting Standards Board's Statements No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments* and No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*, only one year of information is presented in the financial statements and this discussion. Comparative information will be presented in future years.

Using This Annual Report

This report consists of three basic financial statements. The statement of net assets; the statement of revenues, expenses, and changes in net assets; and the statement of cash flows provide information on the University of Tennessee as a whole and present a long-term view of the university's finances.

The Statement of Net Assets

The statement of net assets presents the financial position of the university at the end of the fiscal year and includes all assets and liabilities of the university. The difference between total assets and total liabilities—net assets—is an indicator of the current financial condition of the university. Assets and liabilities are generally measured using current values. Capital assets, however, are stated at historical cost less an allowance for depreciation.

Net assets are divided into three major categories. The first category, invested in capital assets, net of related debt, provides the university's equity in property, plant, and equipment owned by the university. The next asset category is restricted net assets, which is divided into two categories, nonexpendable and expendable. The corpus of nonexpendable restricted resources is only available for investment purposes. Expendable restricted net assets are available for expenditure by the university but must be spent for purposes as determined by donors and/or external entities that have placed time or purpose restrictions on the use of the assets. The final category is unrestricted net assets. These net assets are available to the university for any lawful purpose of the institution.

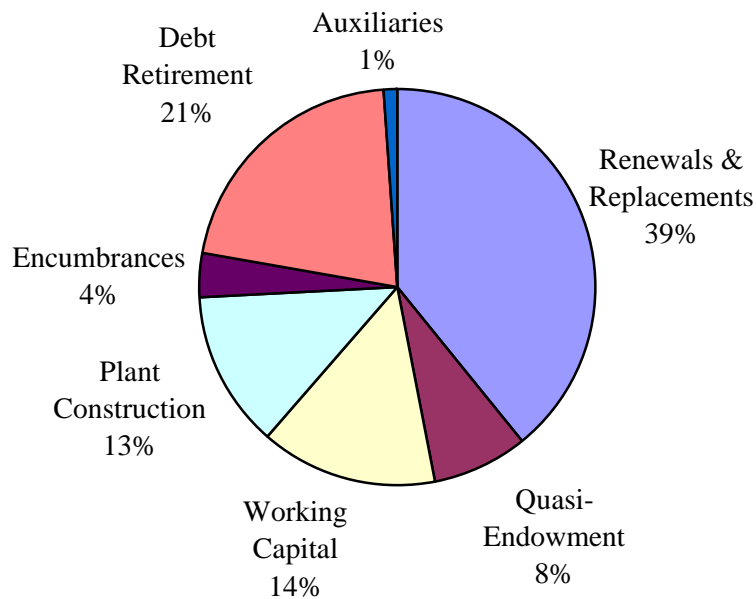
Statement of Net Assets
(in thousands of dollars)

	<u>2002</u>
Assets:	
Current assets	\$315,277
Capital assets, net	835,132
Other assets	792,255
Total Assets	<u>\$1,942,664</u>
Liabilities:	
Current liabilities	\$217,460
Noncurrent liabilities	275,259
Total Liabilities	<u>\$492,719</u>
Net Assets:	
Invested in capital assets, net of related debt	\$636,282
Restricted – expendable	287,057
Restricted – nonexpendable	292,187
Unrestricted	234,419
Total Net Assets	<u>\$1,449,945</u>

Material assets consist of cash and cash equivalents; investments; accounts, notes, and grants receivable; and capital assets. Material liabilities include long-term bonded debt, compensated absences, and deferred revenue.

Many of the university's unrestricted net assets have been designated or reserved for specific purposes such as repairs and replacement of capital assets, future debt service, quasi-endowments, and capital projects. The following graph shows the allocations:

Unrestricted Net Assets



The Statement of Revenues, Expenses, and Changes in Net Assets

The statement of revenues, expenses, and changes in net assets presents the operating results of the university, as well as the nonoperating revenues and expenses. Annual state appropriations, while budgeted for operations, are considered nonoperating revenues according to generally accepted accounting principles.

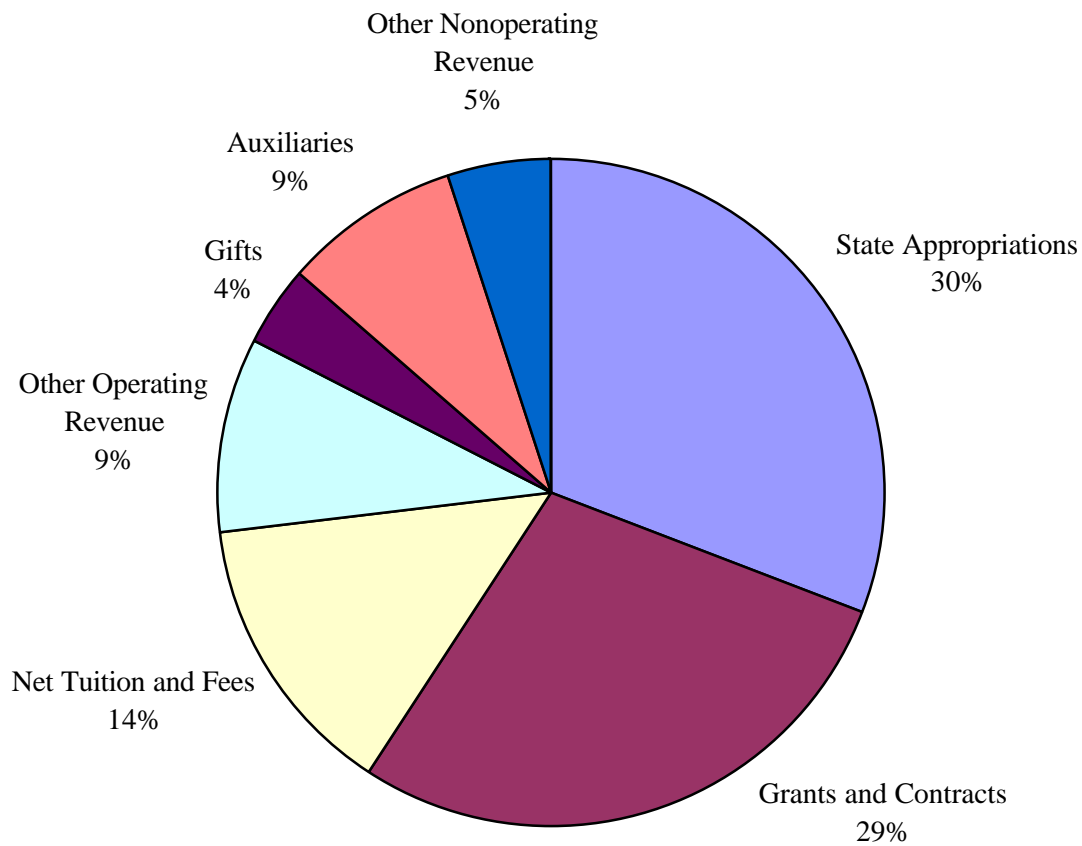
Statement of Revenues, Expenses and Changes in Net Assets
(in thousands of dollars)

	<u>2002</u>
Operating revenues:	
Net tuition and fees	\$189,143
Auxiliary	120,549
Grants and contracts	343,616
Other	128,829
Total operating revenues	<u>782,137</u>
Operating expenses	<u>1,291,222</u>
Operating loss	<u>(509,085)</u>
Nonoperating revenues and expenses:	
State and local appropriations	419,793
Gifts	50,851
Loss on investments	(3,104)
Other	26,760
Total nonoperating revenues	<u>494,300</u>
Income (loss) before other revenues, expenses, gains, or losses	<u>(14,785)</u>
Other revenues, expenses, gains, or losses:	
Capital appropriations	34,102
Capital grants and gifts	8,859
Additions to permanent endowments	23,128
Other	986
Total other revenues, expenses, gains, or losses	<u>67,075</u>
Increase (decrease) in net assets	<u>52,290</u>
Net assets at beginning of year	2,284,168
Cumulative effect of changes in accounting principle	<u>(886,513)</u>
Net assets at end of year	<u>\$1,449,945</u>

Revenues

The following is a graphic illustration of revenues by source (both operating and nonoperating), which were used to fund the university's activities for the year ended June 30, 2002.

REVENUES BY SOURCE



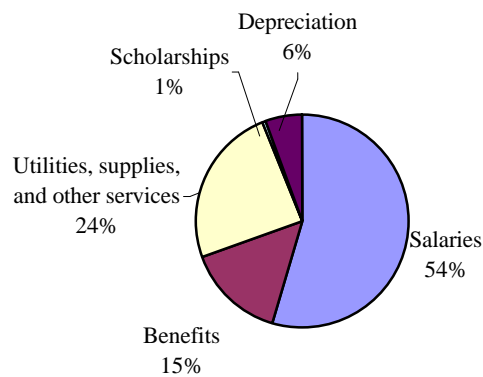
Seventy-three percent of UT's revenue is attributed to state appropriations, grants and contracts, and tuition and fees.

Expenses

Operating expenses can be displayed in two formats, natural classification and functional classification. Both formats are displayed below (in thousands of dollars).

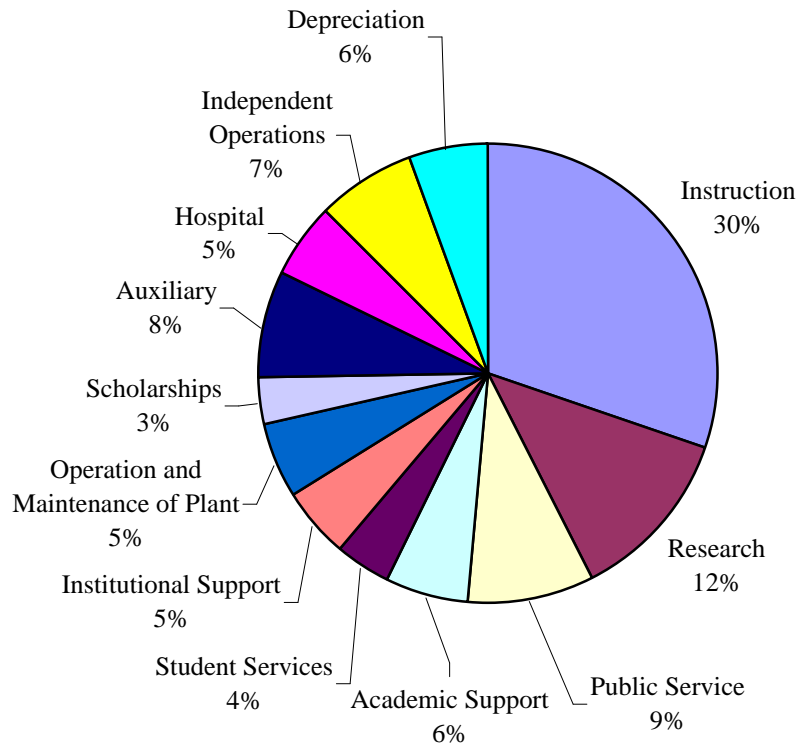
<u>Functional Classification</u>	<u>Natural Classification</u>					<u>Total</u>
	<u>Salaries</u>	<u>Benefits</u>	<u>Utilities, Supplies, and Other Services</u>	<u>Scholarships</u>	<u>Depreciation</u>	
Instruction	\$275,198	\$66,427	\$50,983	\$ -	\$ -	\$392,608
Research	87,489	18,011	51,277	-	-	156,777
Public service	64,132	15,839	35,379	-	-	115,350
Academic support	49,270	13,541	12,374	-	-	75,185
Student services	24,898	6,354	16,273	-	-	47,525
Institutional support	51,158	14,768	443	-	-	66,369
Operation and maintenance of plant	24,593	7,900	36,708	-	-	69,201
Scholarships	2,752	21,637	11,052	7,816	-	43,257
Auxiliary	29,431	7,556	59,876	-	-	96,863
Hospital	19,829	4,743	40,969	-	-	65,541
Independent operations	72,456	18,693	-	-	-	91,149
Depreciation	-	-	-	-	71,397	71,397
Total Expenses	\$701,206	\$195,469	\$315,334	\$7,816	\$71,397	\$1,291,222

Operating Expenses by Natural Classification



Approximately 69 percent of operating expenses are attributed to salaries and benefits. Utilities, supplies, and other services represent 24 percent of total operating expenses. Scholarships and depreciation represent the remaining 7 percent of operating expenses.

Operating Expenses by Function



Fifty-one percent of operating expenses by function is attributable to instruction, research, and public service. The percentages for the remaining functional areas range from 3 to 8 percent of total operating expenses.

The Statement of Cash Flows

The statement of cash flows provides information about cash receipts and cash payments during the year. This statement also assists users in assessing the university's ability to generate net cash flows, its ability to meet its obligations as they come due, and its need for external financing.

Statement of Cash Flows (in thousands of dollars)

	<u>2002</u>
Cash provided (used) by:	
Operating activities	\$(440,257)
Noncapital financing activities	477,018
Investing activities	16,603
Capital and related financing activities	<u>(72,273)</u>
Net increase (decrease) in cash	\$(18,909)
Cash, beginning of year	<u>\$388,746</u>
Cash, end of year	<u><u>\$369,837</u></u>

Material sources of cash included state appropriations, tuition and fees, and grants and contracts. Material uses of cash are reflected in payments to suppliers and vendors, payments to employees, and payments for scholarships and fellowships.

The net decrease in cash and cash equivalents amounted to \$18,908,968 for the year ended June 30, 2002.

Capital Asset and Debt Administration

Capital Assets

At June 30, 2002, the University of Tennessee had \$835,131,910.90 invested in capital assets, net of accumulated depreciation. Depreciation charges totaled \$71,396,612.07 for the current fiscal year. Details of these assets are shown below.

Schedule of Capital Assets, Net of Depreciation (in thousands of dollars)

	<u>2002</u>
Land	\$45,102
Land improvements & infrastructure	29,508
Buildings	510,160
Equipment	93,922
Software	10,883

Library holdings	46,333
Projects in progress	99,223
Total	<u>\$835,131</u>

Major capital additions for UT during 2001-2002 include fire safety upgrades and HVAC improvements for several residence halls on the Knoxville campus, improvements of \$7.3 million to Brehm Hall in Martin, and the \$12.4 million completion of Phase III of the Witten/Link/Faculty Building at the Health Science Center in Memphis.

For the next fiscal year, the state has approved more than \$14.5 million in capital maintenance appropriations for UT. Some of these approved projects include the roof replacements of several buildings on the Knoxville and Memphis campuses, exterior repairs to 11 buildings, and an electrical distribution system upgrade for Chattanooga and Phase IV of a chiller replacement in Knoxville. More detailed information about the university's capital assets is presented in Note 4 to the financial statements.

Debt

At June 30, 2002, the university had \$202,374,564 in debt outstanding. The table below summarizes these amounts by type of debt instrument.

Outstanding Debt Schedule (in thousands of dollars)

	<u>2002</u>
Commercial paper-current portion	\$ 7,457
Bonds-current portion	13,506
Bonds-long term debt	<u>181,401</u>
Total TSSBA authorized debt	\$202,364
Notes-current portion	<u>10</u>
Total Debt	<u><u>\$202,374</u></u>

New debt issuances for the fiscal year 2001-2002 consisted of \$59.9 million for 13 projects. Included in this issuance were two parking garages on the Knoxville campus, the Student Recreation Center in Knoxville, a data network upgrade for the Health Science Center in Memphis, and improvements to the Boling Apartments in Chattanooga. The university retired more than \$17.9 million in bonds and notes in fiscal year 2001-2002. The Tennessee State School Bond Authority (TSSBA), in addition to its authority to issue bonds and notes to finance capital projects, has responsibility for approving all long-term debt of the university. TSSBA currently is rated as AA- by Standard & Poor. More detailed information about the university's long-term liabilities is presented in Note 6 to the financial statements.

Economic Factors That Will Affect the Future

For fiscal year 2002-2003, the University of Tennessee Board of Trustees has authorized a fee increase of 7.5% that is expected to generate approximately \$16 million in new funding, net of related scholarships. The university is also expected to receive a modest increase in state funding mid-year to offset salary and benefit increases provided for in the state fiscal year 2003 budget.

In addition, the university is negotiating with the Methodist Healthcare-Memphis Hospital to manage and operate the William F. Bowld Hospital and subsequently merge the William F. Bowld Hospital operations into the downtown operations of the Methodist Hospital.

THE UNIVERSITY OF TENNESSEE
STATEMENT OF NET ASSETS
June 30, 2002

ASSETS

Current assets:	
Cash and cash equivalents (Note 2)	\$ 158,661,157.27
Investments (Note 2)	50,067,193.46
Accounts, notes, and grants receivable (net) (Note 3)	92,987,084.86
Inventories	10,117,661.10
Prepaid expenses and deferred charges	3,443,491.06
Total current assets	<u>315,276,587.75</u>
Noncurrent assets:	
Restricted cash and cash equivalents (Note 2)	211,175,901.67
Investments (Note 2)	394,092,252.68
Assets with trustees (Note 2)	4,620,808.00
Investment in UT - Battelle, LLC (Note 10)	1,789,206.24
Accounts, notes, and grants receivable (net) (Note 3)	164,305,023.16
Lease payments receivable (Note 14)	16,272,083.36
Capital assets (net) (Note 4)	835,131,910.90
Total noncurrent assets	<u>1,627,387,186.01</u>
Total assets	<u>1,942,663,773.76</u>

LIABILITIES

Current liabilities:	
Accounts payable	62,242,891.07
Accrued liabilities	34,720,912.03
Deferred revenue	63,148,100.33
Deposits payable	4,045,375.64
Annuities payable	1,619,887.96
Long term liabilities, current portion (Note 6)	44,891,263.75
Deposits held in custody for others	6,791,205.53
Total current liabilities	<u>217,459,636.31</u>
Noncurrent liabilities:	
Deferred revenue	15,500,438.71
Long term liabilities, noncurrent portion (Note 6)	216,672,855.11
Due to grantors	34,507,427.06
Annuities payable	8,578,451.55
Total noncurrent liabilities	<u>275,259,172.43</u>
Total liabilities	<u>492,718,808.74</u>

NET ASSETS

Invested in capital assets, net of related debt	636,282,040.58
Restricted:	
Nonexpendable:	
Scholarships and fellowships	118,255,494.41
Libraries	12,309,193.69
Research	9,685,452.75
Instructional department uses	47,433,556.32
Other	99,372,857.34
Expendable:	
Scholarships and fellowships	90,834,768.15
Libraries	4,046,989.13
Research	32,480,248.62
Instructional department uses	37,500,480.72
Loans	8,346,883.77
Capital projects	3,464,394.12
Debt service	592,815.76
Other	114,920,718.49
Unrestricted (Note 16)	<u>234,419,071.17</u>
Total net assets	<u>\$ 1,449,944,965.02</u>

The notes to the financial statements are an integral part of this statement.

THE UNIVERSITY OF TENNESSEE
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
For the Year Ended June 30, 2002

REVENUES

Operating revenues:

Student tuition and fees (net of scholarship allowances of \$31,687,598.45)	\$ 189,142,951.97
Federal appropriations	13,760,809.80
Governmental grants and contracts	189,090,028.66
Non-governmental grants and contracts	154,525,909.50
Sales and services of educational departments	37,554,072.87

Auxiliary enterprises:

Residential life (net of scholarship allowances of \$986,407.82; all revenues are used as security for varying revenue bonds; Note 6)	29,485,142.09
Food services	2,661,886.18
Bookstore	20,407,597.39
Parking	7,669,470.48
Athletics	54,586,749.14
Other auxiliaries	5,738,310.24
Hospital	57,814,869.56
Interest earned on loans to students	82,818.70
Other operating revenues	19,616,431.68
Total operating revenues	<u>782,137,048.26</u>

EXPENSES

Operating expenses:

Salaries and wages	701,206,933.17
Fringe benefits	195,469,039.04
Utilities, supplies, and other services	315,333,196.68
Scholarships and fellowships	7,816,121.78
Depreciation expense	71,396,612.07
Total operating expenses	<u>1,291,221,902.74</u>
Operating income (loss)	<u>(509,084,854.48)</u>

NONOPERATING REVENUES (EXPENSES)

State and local appropriations	419,792,940.89
Gifts	50,851,804.57
Grants and contracts	46,905,377.96
Loss on investments	(3,104,052.28)
Interest on capital asset - related debt	(9,757,152.23)
Bond issuance costs	(434,669.40)
Other nonoperating expenses	(9,954,658.64)
Net nonoperating revenues	<u>494,299,590.87</u>
Income before other revenues, expenses, gains, or losses	(14,785,263.61)
Capital appropriations	34,102,220.31
Capital grants and gifts	8,859,062.66
Additions to permanent endowments	23,127,540.82
Additions to annuity and life income trusts	811,482.57
Other	174,973.67
Total other revenues	<u>67,075,280.03</u>
Increase in net assets	52,290,016.42

NET ASSETS

Net assets at beginning of year	2,284,168,171.87
Cumulative effect of changes in accounting principle (Note 18)	(886,513,223.27)
Net assets at beginning of year, as restated	<u>1,397,654,948.60</u>
Net assets at end of year	<u>\$ 1,449,944,965.02</u>

The notes to the financial statements are an integral part of this statement.

THE UNIVERSITY OF TENNESSEE
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2002

CASH FLOWS FROM OPERATING ACTIVITIES

Tuition and fees	\$ 189,281,671.03
Federal appropriations	13,760,809.80
Grants and contracts	333,499,903.17
Sales and services of educational activities	44,579,120.00
Payments to suppliers and vendors	(325,459,746.84)
Payments to employees	(693,931,502.51)
Payments for benefits	(190,025,977.97)
Payments for scholarships and fellowships	(21,285,322.62)
Loans issued to students	(5,632,359.39)
Collection of loans from students	5,077,750.49
Interest earned on loans to students	800,168.82
Auxiliary enterprise charges:	
Residence halls	30,917,997.01
Bookstore	24,512,571.63
Food service	2,981,467.22
Parking	8,543,972.18
Athletics	53,717,774.43
Other auxiliaries	6,284,683.76
Hospital	54,798,356.37
Other receipts (payments)	27,321,715.35
Net cash provided (used) by operating activities	<u>(440,256,948.07)</u>

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

State appropriations	411,372,497.00
Local appropriations	3,871,848.89
Gifts and grants for other than capital or endowment purposes	73,281,681.11
Private gifts for endowment purposes	20,780,921.37
Split-interest transactions receipts	3,793,928.77
Split-interest transactions disbursements	(3,630,549.03)
Federal student loan receipts	117,823,747.00
Federal student loan disbursements	(117,823,747.00)
Changes in deposits held for others	(2,863,304.06)
Net cash balance implicitly financed (repaid)	(29,326,447.36)
Other noncapital receipts (payments)	(262,554.08)
Net cash provided (used) by noncapital financing activities	<u>477,018,022.61</u>

CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES

Proceeds from capital debt	21,593,783.49
Capital appropriations	29,884,165.40
Capital grants and gifts received	4,871,265.30
Proceeds from sale of capital assets	1,085,999.17
Purchase of capital assets and construction	(101,670,770.44)
Principal paid on capital debt and leases	(17,919,300.85)
Interest paid on capital debt and leases	(8,848,537.01)
Deposit with trustee	373,749.29
Other capital and related financing receipts (payments)	(1,643,821.31)
Net cash provided (used) by capital and related financing activities	<u>(72,273,466.96)</u>

CASH FLOWS FROM INVESTING ACTIVITIES

Proceeds from sales and maturities of investments	90,349,133.87
Interest on investments	38,704,585.56
Purchase of investments	(112,450,295.55)
Net cash provided (used) by investing activities	<u>16,603,423.88</u>

Net increase (decrease) in cash and cash equivalents	(18,908,968.54)
Cash and cash equivalents at beginning of year	388,746,027.48
Cash and cash equivalents at end of year	<u>\$ 369,837,058.94</u>

THE UNIVERSITY OF TENNESSEE
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2002

**RECONCILIATION OF NET OPERATING LOSS TO NET CASH
PROVIDED (USED) BY OPERATING ACTIVITIES**

Operating loss	\$ (509,084,854.48)
Adjustments to reconcile operating loss to net cash provided (used) by operating activities:	
Depreciation expense	71,396,612.07
Other adjustments	472,827.11
Changes in assets and liabilities:	
Receivables, net	(14,618,397.39)
Inventories	(706,745.03)
Prepaid expenses and deferred charges	(802,529.73)
Accrued interest receivable	717,350.12
Accounts payable	(12,958,195.29)
Accrued liabilities	15,730,038.07
Deferred revenue	5,151,799.28
Deposits	532,046.97
Compensated absences	4,467,709.13
Other additions:	
Loans to students	(554,608.90)
Net cash provided (used) by operations	<u>\$ (440,256,948.07)</u>

The notes to the financial statements are an integral part of this statement.

The University of Tennessee
Notes to the Financial Statements
June 30, 2002

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The university is a component unit of the State of Tennessee, and is discretely presented in the *Tennessee Comprehensive Annual Financial Report*. Although the university is a separate legal entity, the state is financially accountable for the university because the state appoints a majority of its governing body and provides financial support.

The University of Tennessee System is comprised of the University of Tennessee, the University of Tennessee at Chattanooga, and the University of Tennessee at Martin. The University of Tennessee is comprised of the University of Tennessee Knoxville campus; the University of Tennessee - Center for the Health Sciences, including the Memphis campus, the Memorial Research Center at Knoxville, Clinical Education Centers at Chattanooga and Knoxville, Family Practice Centers at Jackson, Knoxville, and Memphis, and a hospital in Memphis; the University of Tennessee Space Institute at Tullahoma; the University of Tennessee Institute of Agriculture, including the College of Agriculture at Knoxville, the Agricultural Experiment Stations, the Agricultural Extension Service, and the College of Veterinary Medicine at Knoxville; the Institute for Public Service, which includes the County Technical Assistance Service and the Municipal Technical Advisory Service; and the University-Wide Administration. The university is governed by a board of 23 members, including one student and one faculty member, all either *ex officio* or appointed by the Governor, who also serves as chairman. The president is the chief executive officer of the university system.

The university benefits from a number of organizations that exist mainly to support the various purposes and activities of the university system. These organizations include student organizations; the University Faculty Association; the University of Tennessee Foundation; the University Physicians Foundation; the University of Chattanooga Foundation; the Tennessee Geographic Alliance; Tristar Enterprises; the University of Tennessee Research Corporation; and the Tennessee 4-H Club Foundation. In addition, the university is a participant in a joint venture with Battelle Memorial Institute called UT-Battelle, LLC, which was established for the sole purpose of management and operation of the Oak Ridge National Laboratory for the U. S. Department of Energy. Each of these organizations is legally independent. Consequently, none of these organizations is included in the financial statements of the university.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2002

Basis of Presentation

The financial statements have been prepared in conformity with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board (GASB). In June 1999, the GASB issued Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. This was followed by GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*. The financial statement presentation required by those statements provides a comprehensive, entity-wide perspective of the university's assets, liabilities, net assets, revenues, expenses, changes in net assets, and cash flows, and replaces the fund-group perspective previously required.

A significant accounting change, adoption of depreciation on capital assets, was made in order to comply with the new requirements.

Basis of Accounting

For financial statement purposes, the university is considered a special-purpose government engaged only in business-type activities. Accordingly, the financial statements have been prepared using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Grants and similar items are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met. All significant interfund transactions have been eliminated.

Private-sector standards of accounting and financial reporting issued prior to December 1, 1989, generally are followed to the extent that those standards do not conflict with or contradict guidance of the Governmental Accounting Standards Board (GASB). The university has the option of following private-sector guidance issued subsequent to November 30, 1989, subject to the above limitation. The university has elected not to follow private-sector guidance issued subsequent to November 30, 1989.

Amounts reported as operating revenues include: 1) tuition and fees, net of waivers and discounts; 2) federal, state, local, and private grants and contracts; 3) sales and services of auxiliary enterprises; 4) sales and services of the university's hospital; and 5) other sources of revenue. Operating expenses for the institution include: 1) salaries and wages; 2) employee benefits; 3) scholarships and fellowships; 4) depreciation; and 5) utilities, supplies, and other services.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2002

All other activity is nonoperating in nature. This activity includes: 1) state appropriations for operations; 2) investment income; 3) interest on capital asset-related debt; 4) non-operating grants and contracts; and 5) gifts.

When both restricted and unrestricted resources are available for use, generally it is the institution's policy to use the restricted resources first.

Inventories

Inventories are valued at the lower of cost or market, based on the retail, specific identification, average cost, or first-in, first-out basis.

Investments

Investments in commercial paper are reported at amortized cost at June 30, 2002. All other investments are reported at fair value.

Capital Assets

Capital assets, which include property, plant, equipment, software, and library holdings, are reported in the statement of net assets at historical cost or at fair value at date of donation, less accumulated depreciation. The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend the assets' useful lives are not capitalized.

A capitalization threshold of \$100,000 is used for buildings, land improvements, and infrastructure. Equipment and software are capitalized when the unit acquisition cost is \$5,000 or greater and the estimated useful life is one year or more. The capitalization threshold for additions and improvements to buildings, infrastructure, and land improvements is also \$100,000.

These assets, with the exception of land, are depreciated using the straight-line method over the estimated useful lives of the assets, which range from 5 to 40 years.

Accounts Payable

Included in accounts payable are checks payable in the amount of \$8,456,321.44 as of June 30, 2002. These amounts represent the sum of checks written in excess of the university's checking account balance because of the use of a controlled disbursement account. In this way, the university maximizes interest income by transferring from an investment account only funds necessary to cover the checks that clear the bank daily.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2002

Compensated Absences

The university's employees accrue annual leave at varying rates, depending on length of service or classification. Some employees also earn compensatory time. Generally, all permanent full-time employees and certain part-time employees are entitled to accrue and carry forward calendar year maximums of 42 days annual vacation leave, except nine-month faculty members who do not accrue annual leave. The amount of these liabilities and their related benefits are reported in the statement of net assets.

Net Assets

The institution's net assets are classified as follows:

Invested in capital assets, net of related debt - This represents the institution's total investment in capital assets, net of outstanding debt obligations related to those capital assets. To the extent debt has been incurred but not yet expended for capital assets, such amounts are not included as a component of invested in capital assets, net of related debt.

Expendable restricted net assets - Expendable restricted net assets include resources in which the university is legally or contractually obligated to spend resources in accordance with restrictions imposed by external third parties.

Nonexpendable restricted net assets - Nonexpendable restricted net assets consist of endowment and similar type funds in which donors or other outside sources have stipulated, as a condition of the gift instrument, that the principal is to be maintained inviolate and in perpetuity, and invested for the purpose of producing present and future income, which may be expendable or added to principal.

Unrestricted net assets - Unrestricted net assets represent resources derived from student tuition and fees, state appropriations, and the sales and services of educational departments, auxiliary enterprises, and the university's hospital. These resources are used for transactions relating to the educational and general operations of the institution, and may be used at the discretion of the institution to meet current expenses for any purpose.

Scholarship Discounts and Allowances

Student tuition and fee revenues, and certain other revenues from students, are reported net of scholarship discounts and allowances in the statement of revenues, expenses, and changes in net assets. Scholarship discounts and allowances are the

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2002

difference between the stated charge for goods and services provided by the university and the amount that is paid by the student and/or third parties making payments on the student's behalf. Certain governmental grants, such as Pell grants, and other federal, state, or nongovernmental programs, are recorded as either operating or nonoperating revenues in the institution's financial statements. To the extent that revenues from such programs are used to satisfy tuition and fees, and other student charges, the institution has recorded a scholarship discount and allowance.

Income Taxes

The university, as a public corporation and an instrumentality of the State of Tennessee, is exempt from federal income taxes under Section 115 of the *Internal Revenue Code*. Contributions to the university are deductible by donors as provided under Section 170 of the *Internal Revenue Code*.

Comparative Data

Comparative financial statements are not presented as the university implemented GASB Statements 34, 35, 37, and 38, and comparative statements are not required. Certain amounts presented in the prior year's data have been reclassified in order to be consistent with the current year's presentation.

NOTE 2. DEPOSITS AND INVESTMENTS

Investment Policy

The University of Tennessee maintains a cash management investment pool that is available for use by all fund groups. State statutes and university investment policies authorize the university's cash management pool to invest in collateralized Tennessee bank or savings and loan association certificates of deposit, U.S. Treasury obligations, U.S. government agency obligations, repurchase agreements of those securities, highest quality commercial paper, prime bankers' acceptances, and money market mutual funds meeting certain criteria.

There are two categories of university assets which are subject to long-term investment: endowments and amounts held in trust under annuity and life income agreements. The investment of these funds is governed by the gift instrument and the investment policies established by the Board of Trustees.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2002

Effective July 1, 1954, the university adopted the policy of investing endowment assets over which it had full investment discretion (and on which the donor or governing gift instrument does not require separate investment) in a Consolidated Investment Pool. This pooling of investments affords closer supervision of the investment portfolio and provides, regardless of size, the advantages of participation in a well-diversified portfolio of domestic and international equities, private equity, bonds, real estate, and hedge funds. All contributing endowments participate in the income and capital appreciation of the Pool on a per-share basis commensurate with its contribution to the Pool. New endowments purchase shares in the Pool at the end of each month at the then current fair value per share, determined by valuing the Pool at month end fair value and dividing by the number of pool units outstanding.

If a donor has not provided specific instructions, state law permits the university to authorize for expenditure the net appreciation (realized and unrealized) of the investments of endowment funds. When administering its power to spend net appreciation, the university is required to consider the university's long- and short-term needs, present and anticipated financial requirements, expected total return on its investments, price-level trends, and general economic conditions. Any net appreciation that is spent is required to be spent for the purposes for which the endowment was established.

The university chooses to spend only a portion of the investment income (including changes in the value of investments) each year. Under the spending plan established by the university, five percent of a three-year moving average of the fair value of endowment investments has been authorized for expenditure. The remaining amount, if any, is retained to be used in future years when the amount computed using the spending plan exceeds the investment income. At June 30, 2002, net appreciation of \$117,997,386.12 is available to be spent, of which \$113,006,575.21 is restricted to specific purposes. The per unit fair value for participating endowments was \$3.229534 at June 30, 2002. Income distributed was \$.18848 per share in 2002 or \$21,833,345.92.

All endowments not invested as part of the Consolidated Investment Pool are separately invested to observe requirements or limitations imposed by donors. Income earned and distributed on separately invested endowments amounted to \$857,163.19 for 2002.

Annuity and life income amounts held in trust are separately invested entities requiring detailed accounting to reflect specific compliance with terms of each trust and applicable federal regulations. The investment objectives as reflected in each agreement vary widely since they are affected by the age, income level, and needs of the

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2002

beneficiaries as well as motives and objectives of the donors. Interest, dividend, rent, and royalty income realized on these funds for 2002 amounted to \$2,321,619.45.

In accordance with state statutes, commercial banks and savings and loan associations that do not participate in the State of Tennessee Collateral Pool for Public Deposits must pledge securities with third parties as collateral to secure university time and demand deposits. Market values of these securities are regularly monitored to ascertain that 105% of university deposits, less the amounts protected by the Federal Deposit Insurance Corporation, are secured.

Cash and Cash Equivalents

In addition to petty cash and demand deposits, this classification includes instruments which are readily convertible to known amounts of cash. At June 30, 2002, cash and cash equivalents consisted of \$19,168,603.03 in bank accounts, \$1,256,697.12 of petty cash on hand, and \$344,641,163.04 in the university's cash management investment pool.

Additionally, the university maintains custodial accounts at First Tennessee Bank for funds contractually managed by independent investment counsel. In accordance with the custody agreement, First Tennessee Bank placed cash equivalents of \$4,770,595.75 at June 30, 2002, in the bank's money market mutual fund.

Deposits

Deposits with financial institutions are required to be categorized to indicate the level of custodial risk assumed by the university. Category 1 consists of deposits that are insured or collateralized with securities held by the university or by its agent in the university's name. Category 2 consists of deposits collateralized with securities held by the pledging financial institution's trust department or agent in the university's name. Category 3 deposits are uncollateralized. This category includes any bank balance that is collateralized with securities held by the pledging financial institution or by its trust department or agent but not in the university's name.

Some of the university's bank accounts are in financial institutions which participate in the bank collateral pool administered by the Treasurer of the State of Tennessee. The securities pledged to protect these accounts are pledged in the aggregate rather than against each individual account. The members of the pool may be required by agreement to pay an assessment to cover any deficiency. Under this additional assessment agreement, public fund accounts covered by the pool are considered to be insured for purposes of credit risk disclosure.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2002

At June 30, 2002, the carrying amount of the university's deposits was \$19,168,603.03, and the bank balance including accrued interest was \$19,839,299.36. The entire bank balance was category 1.

During the year ended June 30, 2002, the university had uncollateralized deposits on several days, ranging from \$88,797.96 to \$ 4,908,084.90.

The laws of the State of Tennessee require that collateral be pledged to secure all uninsured deposits.

Cash Management Investment Pool

The cash management investment pool consists of marketable securities and government repurchase agreements as previously described. The reported amount of the cash management pool at June 30, 2002, was \$344,641,163.04. The cost of the cash management pool at June 30, 2002, was \$340,555,735.26. The reported amount of securities in the pool with a maturity date of three months or less from the date of purchase at June 30, 2002, was \$71,906,888.63. The cost of these same securities at June 30, 2002, was \$71,800,173.90. The securities in the pool are categorized on the following schedule, listed as cash equivalents, to indicate the level of risk assumed by the university. The university's standard "Master Repurchase Agreements" require that the securities underlying repurchase agreements have fair value equal to or exceeding 100% of the cost of the repurchase agreement and that the securities be delivered to its agent's trust account at the Federal Reserve Bank - Memphis. The fair value of securities underlying repurchase agreements was \$18,422,523.77 at June 30, 2002.

Investments

The university's investments are categorized below to indicate the level of custodial risk assumed by the university at year end. Category 1 consists of insured or registered investments or investments for which the securities are held by the university or its agent in the university's name. Category 2 consists of uninsured or unregistered investments for which the securities are held by the counterparty's trust department or agent in the university's name. Category 3 consists of uninsured and unregistered investments for which the securities are held by the counterparty or by its trust department or agent but not in the university's name.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2002

June 30, 2002

	Category			Reported	
	1	2	3	Amount	Cost
Cash equivalents					
Government securities	\$ 235,851,073.59	\$ -	\$ -	\$ 235,851,073.59	\$232,039,352.74
Repurchase agreements	16,000,000.00	2,000,000.00	-	18,000,000.00	18,000,000.00
Commercial paper	90,790,089.45	-	-	90,790,089.45	90,516,382.52
	<u>342,641,163.04</u>	<u>2,000,000.00</u>	<u>-</u>	<u>344,641,163.04</u>	<u>340,555,735.26</u>
Investments					
Domestic securities					
Government securities	8,167,250.35	37,813,080.14	-	45,980,330.49	42,931,731.08
Corporate bonds	4,124,930.21	32,269,301.05	-	36,394,231.26	36,019,872.39
Corporate stocks	119,382,907.29	5,651,149.03	-	125,034,056.32	131,514,349.41
Mortgages and notes	1,199,521.42	-	-	1,199,521.42	1,176,247.37
Other investments	168,538.06	-	-	168,538.06	183,070.74
International securities					
Corporate stocks	591,740.00	-	-	591,740.00	545,037.97
Assets with trustees	-	-	4,620,808.00	4,620,808.00	4,551,601.03
	<u>133,634,887.33</u>	<u>75,733,530.22</u>	<u>4,620,808.00</u>	<u>213,989,225.55</u>	<u>216,921,909.99</u>
	<u>\$ 476,276,050.37</u>	<u>\$ 77,733,530.22</u>	<u>\$ 4,620,808.00</u>		

University cash equivalents and investments not susceptible to categorization:

Cash equivalents - assets with First Tennessee Bank as custodian	4,770,595.75	4,770,595.75
Limited partnership - venture capital funds	29,543,346.75	38,994,767.92
Mutual funds	143,318,009.82	146,547,931.14
Investments in hedge funds	35,025,746.00	40,000,000.00
Real estate equity funds	21,794,167.92	18,316,724.89
Real estate gifts	<u>5,109,758.10</u>	<u>6,270,244.67</u>
Total investments and cash equivalents	798,192,012.93	812,377,909.62
Less: Cash equivalents	<u>349,411,758.79</u>	<u>345,326,331.01</u>
Total investments and assets with trustees	<u>\$ 448,780,254.14</u>	<u>\$ 467,051,578.61</u>

Included in the assets with trustees at June 30, 2002, are securities held in debt service reserve at First Tennessee Bank totaling \$150,157.84, and securities in an interest rate reserve fund with the Tennessee State School Bond Authority totaling \$178,486.68.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2002

The university's assets subject to long term investment (endowments and annuity and life income assets) use various external managers and funds consistent with investment objectives for those invested assets. A significant part of these assets is the university's Consolidated Investment Pool which is a carefully crafted portfolio of broadly diversified asset classes including an alternative asset class comprised of hedge funds. Currently, the Consolidated Investment Pool invests in two hedge funds, the Commonfund Global Hedged Partners and the Balentine Hedge Fund Select. The hedge fund investments expose the university to significant amounts of credit risk and market risk by trading or holding derivative securities and by leveraging the securities in the fund. These investments are briefly described as follows.

Commonfund Global Hedged Partners, LLC, was created in 2000 as a multi-manager fund investing in a diversified group of 17 primarily equity hedge fund managers operating and investing in the United States, Europe, and Asia. Investment strategies are predominantly long/short, but also include international and event-driven arbitrage. The university's investment of \$20,000,000 was valued at \$19,877,020 at June 30, 2002.

Balentine Hedge Fund, L.P., was created in 2000 as a multi-manager partnership. Currently, portfolio assets are allocated among 12 managers with 40% of the managers biased toward net long positions in U.S. large capitalization companies and 60% using widely diverse strategies to moderate overall volatility. These strategies include long equity positions, distressed securities, mortgage-backed securities, and private equity. Effective January 1, 2001, the partnership changed its name to Ballentine Hedge Fund Select, L.P. The university's investment of \$20,000,000 was valued at \$15,148,726 at June 30, 2002.

NOTE 3. ACCOUNTS, NOTES, AND GRANTS RECEIVABLE

Accounts, notes, and grants receivable included the following at June 30, 2002:

Student accounts receivable	\$5,314,582.32
Grants receivable	110,903,868.45
Notes receivable	38,091,186.72
Pledges receivable	42,343,911.71
State capital outlay receivable	11,127,209.61
TSSBA debt proceeds receivable	5,403,996.36
Other receivables	<u>65,130,281.15</u>
Subtotal	278,315,036.32

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2002

Less allowance for doubtful accounts (21,022,928.30)

Total \$257,292,108.02

Pledges receivable are promises of private donations that are reported as accounts receivable and revenue, net of an estimated uncollectible allowance of \$953,740.91.

Federal Perkins Loan Program funds include the following at June 30, 2002:

Perkins loans receivable \$32,812,165.49
Less allowance for doubtful accounts (833,686.81)

Total \$31,978,478.68

NOTE 4. CAPITAL ASSETS

Capital asset activity for the year ended June 30, 2002, was as follows:

	<u>Beginning Balance</u>	<u>Additions</u>	<u>Transfers</u>	<u>Reductions</u>	<u>Ending Balance</u>
Land	\$45,132,874.38	\$228,121.30	\$ -	\$(258,656.00)	\$45,102,339.68
Land improvements and infrastructure	58,041,289.55	58,235.37	(5,834,445.79)	-	52,265,079.13
Buildings	902,485,207.30	4,151,045.99	47,616,393.27	-	954,252,646.56
Equipment	224,451,240.34	29,304,724.57	-	(12,403,925.71)	241,352,039.20
Software	7,587,028.85	2,919,611.18	4,253,201.45	-	14,759,841.48
Library holdings	75,649,507.44	9,652,280.79	-	(5,309,850.43)	79,991,937.80
Projects in progress	<u>87,843,473.10</u>	<u>57,936,820.97</u>	<u>(46,035,148.93)</u>	<u>(522,559.03)</u>	<u>99,222,586.11</u>
Total	1,401,190,620.96	104,250,840.17	-	(18,494,991.17)	1,486,946,469.96
Less accumulated depreciation:					
Land improvements and infrastructure	(20,155,628.34)	(2,601,355.94)	-	-	(22,756,984.28)
Buildings	(406,381,057.57)	(37,711,544.09)	-	-	(444,092,601.66)
Equipment	(137,207,827.19)	(19,684,684.53)	-	9,462,546.59	(147,429,965.13)
Software	(78,812.08)	(3,797,889.85)	-	152.53	(3,876,549.40)
Library holdings	<u>(31,367,171.36)</u>	<u>(7,601,137.66)</u>	<u>-</u>	<u>5,309,850.43</u>	<u>(33,658,458.59)</u>
Total accumulated depreciation	<u>(595,190,496.54)</u>	<u>(71,396,612.07)</u>	<u>-</u>	<u>14,772,549.55</u>	<u>(651,814,559.06)</u>
Capital assets, net	<u>\$806,000,124.42</u>	<u>\$32,854,228.10</u>	<u>\$ -</u>	<u>\$(3,722,441.62)</u>	<u>\$835,131,910.90</u>

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2002

NOTE 5. OPERATING LEASES

The university has entered into various operating leases for buildings and equipment. It is expected that in the normal course of business, such leases will continue to be required. Net expenses for rentals under leases for the year ended June 30, 2002, amounted to \$7,895,144.03.

The following is a schedule of future minimum rental payments required under noncancelable operating leases that have initial or remaining lease terms of more than one year at June 30, 2002. Only one such lease is currently in effect. Annual payments on this particular lease fluctuate in direct proportion to changes in the Consumer Price Index as required by contractual agreement. The schedule below is calculated based on the current Consumer Price Index.

Year Ending <u>June 30</u>	
2003	\$ 11,127.90
2004	11,127.90
2005	11,127.90
2006	11,127.90
2007	11,127.90
2008 - 2012	<u>55,639.50</u>
Total Minimum Payments Required	<u>\$ 111,279.00</u>

NOTE 6. LONG-TERM LIABILITIES

Long-term liability activity for the year ended June 30, 2002, was as follows:

	<u>Beginning Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending Balance</u>	<u>Current Portion</u>
Payables:					
Bonds	\$164,135,512.00	\$61,449,853.53	\$30,677,801.31	\$194,907,564.22	\$13,506,220.25
Commercial paper	<u>27,211,183.50</u>	<u>4,519,042.99</u>	<u>24,273,716.91</u>	<u>7,456,509.58</u>	<u>7,456,509.58</u>
Total TSSBA indebtedness	191,346,695.50	65,968,896.52	54,951,518.22	202,364,073.80	20,962,729.83
Notes	<u>31,009.87</u>	<u>-</u>	<u>20,518.97</u>	<u>10,490.90</u>	<u>10,490.90</u>
Subtotal	191,377,705.37	65,968,896.52	54,972,037.19	202,374,564.70	20,973,220.73

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2002

Other liabilities:

Compensated absences	<u>54,721,845.03</u>	<u>28,385,752.15</u>	<u>23,918,043.02</u>	<u>59,189,554.16</u>	<u>23,918,043.02</u>
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Total long-term liabilities	<u>\$246,099,550.40</u>	<u>\$94,354,648.67</u>	<u>\$78,890,080.21</u>	<u>\$261,564,118.86</u>	<u>\$44,891,263.75</u>
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Tennessee State School Bond Authority (TSSBA) bonds, with interest rates ranging from 3.0% to 7.75%, are due serially to 2032 and are secured by pledges of the facilities' revenue to which they relate and certain other revenues and fees of the university, including state appropriations. The total outstanding bonded indebtedness for the university was \$228,749,618.01 at June 30, 2002. The total bonded indebtedness reported on the statement of net assets at June 30, 2002, is shown net of unaccreted bonds payable of \$4,862,691.80, assets of \$9,911,109.61 held by the Tennessee State School Bond Authority, and unspent bond proceeds of \$19,068,252.38.

Included in the total outstanding indebtedness is a \$242,000.00 note with the Department of Education, which was issued in March 1989. The note carries an interest rate of 3% and is due semi-annually to 2003. The outstanding balance of the note payable at June 30, 2002, was \$10,490.90.

The university's debt service requirements to maturity for all bonds and the Department of Education note payable at June 30 are as follows:

Year Ending <u>June 30</u>	<u>Principal</u>	<u>Interest</u>
2003	\$ 13,516,711.15	\$ 11,577,764.16
2004	13,850,879.95	10,923,409.42
2005	12,285,795.27	10,335,973.99
2006	11,218,017.97	9,817,848.27
2007	11,625,382.34	9,353,448.27
2008-2012	53,098,877.23	39,632,290.89
2013-2017	38,306,097.21	27,593,258.08
2018-2022	34,364,218.81	16,769,597.09
2023-2027	25,446,903.71	8,176,330.90
2028-2032	<u>15,047,225.27</u>	<u>2,378,744.35</u>
	<u>\$228,760,108.91</u>	<u>\$146,558,665.42</u>

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 2002

COMMERCIAL PAPER PROGRAM

The Tennessee State School Bond Authority also authorized the issuance of commercial paper to finance costs of various capital projects. At June 30, 2002, \$7,456,509.58 has been issued for projects at the University of Tennessee.

For the commercial paper program, the Tennessee State School Bond Authority maintains an interest rate reserve fund. The university contributes amounts to the reserve fund based on the amounts drawn. The principal of the reserve will be contributed to pay off notes or credited back to the university when the notes are converted to bonds. The interest earned on the reserve is used to pay interest due during the month.

NOTE 7. PENSION PLANS

Defined Benefit Plans

Tennessee Consolidated Retirement System

Plan Description

The University of Tennessee contributes to the State Employees, Teachers, and Higher Education Employees Pension Plan (SETHEEPP), a cost-sharing multiple-employer defined benefit pension plan administered by the Tennessee Consolidated Retirement System (TCRS). TCRS provides retirement, death, and disability benefits as well as annual cost-of-living adjustments to plan members and their beneficiaries. Title 8, Chapters 34-37, *Tennessee Code Annotated*, establishes benefit provisions. State statutes are amended by the Tennessee General Assembly. The TCRS issues a publicly available financial report that includes financial statements and required supplementary information for SETHEEPP. That report may be obtained by writing to the Tennessee Department of the Treasury, Consolidated Retirement System, 10th Floor, Andrew Jackson Building, Nashville, Tennessee, 37243-0230 or by calling (615) 741-8202.

Funding Policy

Plan members are noncontributory. The university is required to contribute at an actuarially determined rate. The current rate is 6.19% of annual covered payroll. Contribution requirements for the university are established and may be amended by

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the TCRS' Board of Trustees. The university's contributions to TCRS for the years ended June 30, 2002, 2001, and 2000, were \$14,844,243.45, \$14,318,076.01, and \$12,426,308.08, respectively. Contributions met the requirements for each year.

Federal Retirement Program

Plan Description

The University of Tennessee contributes to the Federal Retirement Program, a cost-sharing multiple-employer defined benefit pension plan administered by the Civil Service Retirement System (CSRS) for participants employed prior to January 1, 1984, and the Federal Employees Retirement System (FERS) for participants employed after December 31, 1983. Both systems provide retirement, death, and disability benefits, as well as annual cost-of-living adjustments, to plan members and their beneficiaries. All regular full-time employees of the University of Tennessee Agricultural Extension Service who hold federal appointments for 51% or more of their time are required to participate in either one of the two Federal Retirement Programs. For both systems, benefit provisions are established in federal statutes. Federal statutes are amended by the U.S. Congress.

CSRS and FERS issue publicly available financial reports that include financial statements and required supplementary information. These reports may be obtained by writing to the Office of Personnel Management, Retirement Information Office, P.O. Box 45, Boyers, PA 16017-0045, or by calling (202) 606-0500.

Funding Policy

Participating employees, with some exceptions, are required by federal statute to contribute 7.0% of covered salaries to the CSRS plan. The university is required to contribute 8.51%. Contributions to CSRS for the year ended June 30, 2002, were \$1,368,041.75, which consisted of \$706,073.01 from the university and \$661,968.74 from the employees; contributions for the year ended June 30, 2001, were \$1,802,981.46, which consisted of \$996,255.77 from the university and \$806,725.69 from the employees; and contributions for the year ended June 30, 2000, were \$1,841,878.45, which consisted of \$1,012,825.11 from the university and \$829,053.34 from the employees.

Federal statute requires employees participating in FERS to contribute 0.8% of their salaries to the Basic Benefit Plan. The university is required to contribute 10.7%. In addition, the university is required to contribute 1% of each participant's salary to the Thrift Savings Plan plus up to an additional 4% depending upon employees'

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contributions, which can range from 0 to 10% of their salaries. Contributions for the Basic Benefit Plan were \$995,187.77 for the year ended June 30, 2002, which consisted of \$69,230.98 from employees and \$925,956.79 from the university; \$1,017,264.48 for the year ended June 30, 2001, which consisted of \$87,035.01 from employees and \$930,229.47 from the university; and \$979,328.69 for the year ended June 30, 2000, which consisted of \$93,175.27 from employees and \$886,153.42 from the university. Contributions for the Thrift Savings Plan were \$953,719.31 for the year ended June 30, 2002, which consisted of \$572,187.00 from employees and \$381,532.31 from the university; \$898,677.53 for the year ended June 30, 2001, which consisted of \$562,632.00 from employees and \$336,045.53 from the university; and \$859,548.84 for the year ended June 30, 2000, which consisted of \$531,727.00 from employees and \$327,821.84 from the university. Contributions met the requirements for each year.

Defined Contribution Plans

Optional Retirement Plans (ORP)

The university contributes to three defined contribution plans: Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), Aetna Life Insurance and Annuity Company, and Variable Annuity Life Insurance Company (VALIC). These plans are administered by the Tennessee Department of the Treasury. Each plan provides retirement benefits to faculty and staff who are exempt from the overtime provisions of the Fair Labor Standards Act and who waive membership in TCRS. Benefits depend solely on amounts contributed to the plan plus investment earnings. Plan provisions are established by state statute in Title 8, Chapter 35, Part 4, *Tennessee Code Annotated*. State statutes are amended by the Tennessee General Assembly.

Plan members are noncontributory. The university contributes an amount equal to 10% of the employee's base salary below the social security wage base and 11% above the social security wage base. Contribution requirements are established and amended by state statute. The contribution made by the university to the plans for the year ended June 30, 2002, was \$33,798,169.77 and for the year ended June 30, 2001, was \$32,287,620.57. Contributions met the requirements for each year.

Joint Contributory Retirement System Plan A (JCRS-A)

The Joint Contributory Retirement System Plan A (JCRS-A) is a defined contribution plan with minimum benefits and is administered by the Tennessee Consolidated

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Notes to the Financial Statements (Cont.)
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Retirement System and TIAA-CREF. Employees who were enrolled in the Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF) before July 1977 are members of JCRS-A. Enrollment in this plan for new employees has been closed since July 1977. Although JCRS-A members participate in Aetna, TIAA-CREF, or VALIC, they may also, under certain circumstances, receive a supplementary benefit from the State of Tennessee. Plan provisions are established by *Tennessee Code Annotated*, Chapter 35, Part 4. State statutes are amended by the Tennessee General Assembly.

Plan members are noncontributory. The university's contributions for JCRS-A members were calculated using the base salary amounts of \$52,516,763.29 for fiscal year 2002. Contribution requirements are established and amended by state statute. The contributions are included in the ORP amounts. University contributions to fund the state supplemental benefit totaled \$3,250,790.81 in fiscal year 2002, and \$3,502,655.05 in fiscal year 2001. Contributions met the requirements for each year.

Deferred Compensation Plans

The University of Tennessee offers its employees three deferred compensation plans. The university, through the State of Tennessee, provides two plans, one established pursuant to *Internal Revenue Code (IRC)*, Section 457, and the other pursuant to *IRC*, Section 401(k). The third plan is administered by the university and was established in accordance with *IRC*, Section 403(b). These plans, available to all university employees, permit them to defer a portion of their salaries to future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency. All costs of administering and funding these plans, with the exclusion of the \$20 monthly university match for the Section 401(k) plan, are the responsibility of plan participants.

Since Section 457 and 401(k) plan assets remain the property of the contributing employees, they are not presented in the State of Tennessee financial statements. Effective January 1996, the university began providing a \$20 monthly match from unrestricted current funds for employees making a minimum monthly contribution of \$20 to the Section 401(k) plan. During the year ended June 30, 2002, contributions totaling \$9,101,147.15 were made by employees participating in the plan, with a related match of \$1,920,510.28 made by the university. In accordance with the *IRC*, employee contributions through the 403(b) plan remain the assets of the employee; therefore, these employee contributions are not reflected in the university's financial statements.

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NOTE 8. OTHER POST-EMPLOYMENT BENEFITS

Health care - The State of Tennessee administers a group health insurance program which provides post-employment health insurance benefits to eligible university retirees. This benefit is provided by and administered by the State of Tennessee. The university assumes no liability for retiree health care programs. Information related to this plan is available at the statewide level in the *Tennessee Comprehensive Annual Financial Report*. That report may be obtained by writing to the Tennessee Department of Finance and Administration, Division of Accounts, 312 Eighth Avenue North, 14th Floor, William R. Snodgrass Tennessee Tower, Nashville, TN 37243-0298 or by calling (615) 741-0431.

NOTE 9. AFFILIATED ENTITIES

The University of Chattanooga Foundation, Inc., a private, nonprofit corporation, maintains an endowment fund of which the University of Tennessee at Chattanooga is the sole income beneficiary. The financial records, investments, and other financial transactions of the foundation are not managed by the university and accordingly are not included in these financial statements except for certain endowment assets. During the year ended June 30, 2002, the foundation transferred \$3,920,942.00 to the university for support of designated projects at the Chattanooga campus. In addition, \$1,603,453.00 was expended in 2002 directly by the foundation for the benefit of the University of Tennessee at Chattanooga.

The University of Tennessee Foundation, Inc., was created in October of 2000, with its offices located in Knoxville, Tennessee. The corporation was formed exclusively to benefit the educational, research, and public service missions of the University of Tennessee and its constituent parts. Assets and earnings of the corporation shall be used exclusively for that stated purpose. The corporation qualifies as an organization exempt from federal income taxes under section 501(a) and 501(c)(3) of the *Internal Revenue Code* of 1986 as amended. The financial records, investments, and other financial transactions of the foundation are not managed by the university and accordingly are not included in these financial statements. During the year ended June 30, 2002, the foundation transferred \$766,129.87 to the university to support programs and operations.

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The University of Tennessee board of trustees considered and approved a resolution at the April 2001 board meeting authorizing the University of Tennessee Foundation to accept private gifts for the University of Tennessee, effective July 1, 2001.

Since fiscal year 1985, the Tennessee General Assembly has appropriated \$22 million to a Chairs of Excellence Endowment for the University of Tennessee. The appropriations provided that the Chairs of Excellence Endowment be established as an irrevocable trust with the state treasurer and required the university to match the appropriation on a dollar-for-dollar basis. The university has fully matched 50 chairs as of June 30, 2002. The financial statements of the university include as expenses the amounts expended in the current year to match the state appropriations. The university's statement of net assets does not include the amounts held in trust by the state treasurer. At June 30, 2002, the amounts held in trust totaled \$95,507,998.90 at fair value.

NOTE 10. JOINT VENTURE

The university is a participant in a joint venture with Battelle Memorial Institute for the sole purpose of management and operation of the Oak Ridge National Laboratory (ORNL) for the U. S. Department of Energy. Each entity has a 50% interest in the venture, each having provided an initial investment of \$125,000.00. The university's equity interest at June 30, 2002, was \$1,789,206.24. The university and Battelle each receive a 50% distribution of the ORNL management fee after shared expenses are deducted. The fee distribution for the year ended September 30, 2001, to the university was \$825,555.18. During the year ended June 30, 2002, the university had expenses of \$12,121,816 under contracts with UT-Battelle. Amounts receivable from UT-Battelle under these contracts totaled \$3,820,279 at June 30, 2002. To review the audit report of UT-Battelle, please contact the Controller's Office, The University of Tennessee, 201 Andy Holt Tower, Knoxville, Tennessee 37996-0100.

NOTE 11. INSURANCE-RELATED ACTIVITIES

The state purchases commercial insurance for real property losses above \$5 million per year and surety bond coverage on the state's officials and employees. In the past three fiscal years, the state has not had any claims filed with the commercial insurer. A designation for casualty losses in the amount of \$6.356 million at June 30, 2002, was established in the state's general fund to provide for any property losses not covered by

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the commercial insurance. At June 30, 2002, the scheduled coverage for the university was \$2,228,094,100 for buildings and \$766,847,300 for contents.

The university also carries commercial insurance for losses related to hired and non-owned automobiles, losses related to railroad protection, and losses related to ten university-owned aircraft. Settled claims resulting from these risks have not exceeded commercial insurance coverage in any of the past three fiscal years.

The state has set aside assets for claim settlement in an internal service fund, the Claims Award Fund. This fund services all claims for risk of loss to which the state is exposed, including general liability, automobile liability, professional malpractice, and workers' compensation. The university participates in the Claims Award Fund. The fund allocates the cost of providing claims servicing and claims payment by charging a premium to the university based on a percentage of the university's expected loss costs, which include both experience and exposures. This charge considers recent trends in actual claims experience of the state as a whole. An actuarial valuation is performed as of fiscal year-end to determine the fund liability and premium allocation. Since the university participates in the Claims Award Fund, it is subject to the liability limitations under the provisions of the Tennessee Claims Commission Act, *Tennessee Code Annotated*, Section 9-8-101 et seq. Liability for negligence of the university for bodily injury and property damage is limited to \$300,000 per person and \$1,000,000 per occurrence. The limits of liability under workers' compensation are set forth in *Tennessee Code Annotated*, Section 50-6-101 et seq. Claims are paid through the state's Claims Award Fund. The premium assessed to the university by the Claims Award Fund for the period July 1, 2001, through June 30, 2002, was \$4,286,400.

The state has also set aside assets in the Employee Group Insurance Fund, an internal service fund, to provide a program of health insurance coverage for the employees of the state with the risk retained by the state. The fund allocates the cost of providing claims servicing and claims payment by charging a premium to the university based on estimates of the ultimate cost of claims that have been reported but not settled and of claims that have been incurred but not reported. Employees and providers have 13 months to file medical claims. All assets, liabilities, and payments are administered by the state. At June 30, 2002, 11,912 university employees were enrolled in the basic plan or Health Maintenance Organization.

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NOTE 12. CONTINGENCIES AND COMMITMENTS

Construction Commitment

The university has contractual obligations for the construction of new buildings and additions to and renovations of existing buildings. The outstanding commitments under such contracts at June 30, 2002, were \$58,886,211.99.

Sick Leave

The university records the cost of sick leave when paid. Generally, since sick leave (earned one day per month with unlimited accumulation) is paid only when an employee dies or is absent due to illness or injury, there is no liability for sick leave at June 30, 2002. The amount of unused sick leave at June 30, 2002, was \$188,177,974.57.

Grants and Contracts

The university receives grants and contracts from various federal and state agencies to fund research and other activities. The costs, both direct and indirect, charged to these grants and contracts are subject to audit and disallowance by the granting agency. The university administration believes that any disallowance or adjustments would not have a material effect on the university's financial position.

Nonvested Equipment

Equipment in the possession of the university valued at \$4,148,188.59 as of June 30, 2002, is not reflected in the financial statements. This equipment was purchased with restricted grant and contract funds and other funds, and title has not yet transferred to the university.

Litigation

The university is involved in several lawsuits, none of which are expected to have a material effect on the financial position of the university.

NOTE 13. LEASE AND TRANSFER OF UT MEMORIAL RESEARCH CENTER AND HOSPITAL

On July 29, 1999, the university transferred ownership and control of its hospital located in Knoxville to University Health Systems, Inc., (UHS), an independent, private, not-for-profit organization operating under its own *Internal Revenue Code*,

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Section 501(c)(3) designation. The lease and transfer of the hospital from the university to UHS was accomplished through three main agreements: the Lease and Transfer Agreement, the Employee Services Agreement, and the Affiliation Agreement. Each of these agreements is summarized below.

Lease and Transfer Agreement

Pursuant to the enabling legislation, *Tennessee Code Annotated*, Section 49-9-112 and Section 49-9-1301 et seq., UHS leased from the university the real property of the existing hospital and the Graduate School of Medicine. (See also Note 14.) The term of the lease is 50 years. The university also transferred to UHS all operating assets of the hospital. The consideration for the lease of the real property and transfer of the operating assets was payment by UHS of a) a sum sufficient to economically defease all of the debt issued by the Tennessee State School Bond Authority in the amount of \$149,080,353.69, b) \$25,000,000.00 paid to the university at closing, and c) a variable lease obligation of \$50,000,000.00 to be paid to the university over twenty years. UHS assumed all prior hospital liabilities, known or unknown. In 2019, the university and UHS have agreed to negotiate an annual lease payment for the remaining 30 years of the lease.

Employee Service Agreement

UHS has leased from the university all hospital employees as of the date of closing. UHS has paid to the university the amounts incurred by the university to pay the direct expenses relating to the hospital employees, including wages, salaries, and fringe benefits. These payroll expenses on behalf of UHS, totaling \$91,146,720.15, are reported as operating expenses in the statement of revenues, expenses, and changes in net assets. An equal amount of operating revenue is reported in the non-governmental grants and contracts category. The term of the Employee Service Agreement is 50 years. All persons who began service at the hospital after the date the employee service agreement was signed are employees of UHS and not university employees.

Affiliation Agreement

The university and UHS agreed that UHS will continue to support the Graduate School of Medicine by providing appropriate facilities and resources of the hospital to the faculty and students at the Graduate School of Medicine. UHS agreed to pay the university \$1,500,000 at closing for the benefit of the Graduate School of Medicine. In addition, UHS must pay monthly to the university, for the benefit of the Graduate School of Medicine, the government funding, direct and indirect medical education

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funds, TennCare medical education funds, and other medical education funds received by UHS for the benefit of the Graduate School of Medicine. The amount payable by UHS shall be reduced by a) the fair market rental value of the space provided to the Graduate School of Medicine; b) the fair market value of the information system, telecommunication, network infrastructure, and human resource services provided by UHS to the Graduate School of Medicine; and c) retroactive adjustments made by payers to the graduate medical education payments.

NOTE 14. CAPITAL LEASE OF REAL PROPERTY TO UNIVERSITY HEALTH SYSTEMS, INC.

The university's leasing operations consist exclusively of leasing the real property of the UT Memorial Research Center and Hospital to UHS for a term of 50 years. This lease is pursuant to the Lease and Transfer Agreement described in Note 13. This lease is classified as a direct financing lease. The guaranteed lease payment of \$50 million will be paid by UHS in annual payments through 2019. The amount of the annual payments will equal the lesser of 1) 20% of the hospital's net operating profit for the applicable calendar year; or 2) \$3 million or the greater amount resulting from the application of an index, as specified in the agreement. The payment of \$50 million is guaranteed by December 31, 2019. In 2019, the university and UHS have agreed to negotiate an annual lease payment for the remaining 30 years of the lease. An annual lease payment to the university during the year ended June 30, 2002, totaled \$3,074,544.00.

The university recorded a lease payment receivable in the amount of \$16,272,083.36 which represents the net present value of the guaranteed \$50 million discounted at 5.75%. The minimum lease payments to be received amount has been adjusted upward to reflect a contractually required adjustment to the final required lease payment.

Total minimum lease payments to be received	\$47,948,734.52
Less: Unearned income	<u>(31,676,651.16)</u>
Net investment in direct financing lease	<u>\$16,272,083.36</u>

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NOTE 15. NATURAL CLASSIFICATIONS WITH FUNCTIONAL CLASSIFICATION

The university's operating expenses by functional classification for the year ended June 30, 2002, are as follows:

<u>Functional Classification</u>	<u>Natural Classification</u>					
	<u>Salaries</u>	<u>Benefits</u>	<u>Utilities, Supplies, and Other Services</u>	<u>Scholarships</u>	<u>Depreciation</u>	<u>Total</u>
Instruction	\$275,198,243.78	\$66,426,641.85	\$50,982,869.52	\$ -	\$ -	\$392,607,755.15
Research	87,488,829.89	18,011,441.43	51,276,562.72	-	-	156,776,834.04
Public service	64,131,577.73	15,839,216.03	35,378,604.28	-	-	115,349,398.04
Academic support	49,270,311.49	13,541,421.83	12,374,035.41	-	-	75,185,768.73
Student services	24,898,362.95	6,354,629.93	16,273,821.90	-	-	47,526,814.78
Institutional support	51,158,086.26	14,768,486.25	442,622.77	-	-	66,369,195.28
Operation & maintenance of plant	24,593,358.95	7,900,158.39	36,708,006.14	-	-	69,201,523.48
Scholarships & fellowships	2,752,335.69	21,637,370.03	11,051,956.14	7,816,121.78	-	43,257,783.64
Auxiliary	29,430,866.07	7,555,825.77	59,875,566.86	-	-	96,862,258.70
Hospital	19,828,880.62	4,743,207.12	40,969,150.94	-	-	65,541,238.68
Independent operations	72,456,079.74	18,690,640.41	-	-	-	91,146,720.15
Depreciation	-	-	-	-	71,396,612.07	71,396,612.07
Total	<u>\$701,206,933.17</u>	<u>\$195,469,039.04</u>	<u>\$315,333,196.68</u>	<u>\$7,816,121.78</u>	<u>\$71,396,612.07</u>	<u>\$1,291,221,902.74</u>

NOTE 16. UNRESTRICTED NET ASSETS

Unrestricted net assets include funds that have been designated or reserved for specific purposes. These purposes include the following:

	<u>Amount</u>
Working capital	\$ 33,841,754.80
Encumbrances	8,553,587.76
Auxiliaries	2,766,136.62
Quasi-endowments	17,802,279.40
Plant construction	30,001,493.22

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Renewal and replacement of capital assets	91,941,296.66
Debt retirement	<u>49,512,522.71</u>
Total	<u>\$234,419,071.17</u>

NOTE 17. PRIOR PERIOD ADJUSTMENT

As of June 30, 2001, the university had not recognized \$3,300,000.00 of contractual adjustments related to the patient service revenues of Bowld Hospital in Memphis. (Contractual adjustments are the differences between revenue at established rates and the amounts realizable from third-party payors under contractual agreements.) The contractual adjustments were included in the hospital's separate, internal financial statements, but were not recorded on the university's general ledger. As a result, for the year ended June 30, 2002, the university's beginning net assets have been decreased by \$3,300,000.00.

NOTE 18. CUMULATIVE EFFECT OF CHANGES IN ACCOUNTING PRINCIPLE

The university implemented GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments* and GASB No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*. The university also implemented GASB Statement 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*, and GASB Statement 38, *Certain Financial Statement Note Disclosures*. As a result of this implementation, the university was required to adopt the depreciation of its capital assets, with accumulated depreciation totaling \$595,190,496.55 at the beginning of the year. The university was also required to recognize certain deferred revenue originating under its grant and contract agreements, totaling \$30,731,024.69 at the beginning of the year. In addition, the university was required to reduce amounts due from the Tennessee State School Bond Authority by \$6,165,813.65 at the beginning of the year. The cumulative effect of this change in accounting principle is reported as a \$632,087,334.89 decrease in beginning net assets.

During the year ended June 30, 2002, the university also changed its capitalization threshold for buildings, land improvements, and infrastructure from \$50,000 to \$100,000, discontinued the capitalization of its livestock assets, and changed its

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method of capitalizing library holdings. As a result, capital assets decreased by \$35,869,397.59, \$2,080,071.25, and \$182,712,016.56, respectively. This cumulative effect of a change in accounting principle, totaling \$220,661,485.40 is also reported as a restatement to beginning net assets.

The university also changed its method of accounting for accumulated federal capital contributions associated with its federal loan programs. At June 30, 2001, industry practice required the reporting of these amounts as a fund balance. During the year ended June 30, 2002, industry practice changed, and these amounts were to be reported as a liability. As a result, for the year ended June 30, 2002, beginning net assets were reduced by \$33,764,402.98.

NOTE 19. SUBSEQUENT EVENTS

William F. Bowld Hospital

The university is negotiating with the Methodist Healthcare-Memphis Hospitals to manage and operate the William F. Bowld Hospital and subsequently merge the William F. Bowld Hospital operations into the downtown operations of the Methodist Hospital.